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DEBORAH PRYCE, CHAIRMAN

How Gasoline is Priced at Retail

To understand how gasoline prices are set at retail motor fuel outlets, it is also necessary to have some knowledge of how prices are set at the wholesale -- or bulk or "rack" -- level of gasoline distribution. This knowledge of rack pricing practices is necessary because the lion's share of retail gasoline prices is determined by wholesale prices.

Retail Gasoline Prices

- At their core, retail gasoline prices are set based upon two primary factors -- product replacement costs and profit maximization in the context of a competitive market:
    - In an ascending market (when wholesale prices are increasing), gasoline retailers must set retail prices at a level that will permit them to generate sufficient cash to replace the gasoline sold; in a descending market, the same maxim holds; and,
    - As with any seller of goods, a gasoline retailer would like to maximize its profits -- however, gasoline marketing is an extremely competitive industry and robust competition for customers checks this profit maximization goal.
- The wholesale price a retailer pays for a gallon of gasoline is the major component of how a gasoline marketer prices at retail. As gasoline prices at wholesale increase, retail prices tend to follow, albeit generally with a one to three day lag. The same is true when wholesale prices decrease -- the retail market tends to follow the wholesale market down.
- In setting their retail prices to be posted at their outlets, gasoline marketers attempt, if competition in their local markets permits, to add to their wholesale cost of gasoline the following costs and expenses:
    - Federal, state, and local excise and sales taxes (mandatory payments -- federal -- 23.3 cents per gallon; state and local -- between 20 and 60 cents per gallon);
    - Transportation fees (1 to 3 cents per gallon, depending on distance);
    - Credit card transaction fees (generally set as a percentage of the price of each transactions and range from 1 to 4 percent);
    - Retailer overhead (employee wages, rent, electricity, and other costs of doing business); and

  - Retailer net profit (varies from day to day and market to market -- retailer net profits can range from negative numbers to approximately 10 cents per gallon).
- It is important when examining retail gasoline prices to distinguish between gross retail margins (the difference between the tax-paid wholesale cost of gasoline and the retail price of gasoline at the dispenser) and net retail margins (the gross retailer margin minus the costs of doing business outlined above). For example, a gross retail margin of 10 cents per gallon may well result in a net retail margin of 1 cent or less per gallon once all retailer costs are taken into account.
- In addition, gasoline marketers must set their retail prices based on the cost of replacing the gasoline currently at their retail locations, not the cost of that product itself. Retailers must generate sufficient cash from their current retail sales to purchase their next delivery of gasoline; otherwise, retailers would be constantly using debt to finance their gasoline purchases, a situation that would be sure to harm a retailer's business at some point in the volatile gasoline retail markets.
- Finally, local price competition in a retailer's area may overwhelm all of these factors in a retailer's decision as to where to set its retail gasoline price. If close competitors are priced lower than a retailer's costs, then a retailer may have no business choice but to move its retail price lower to meet competition and maintain the volume of its retail sales. Consequently, depending on local and regional competition and market conditions, a gasoline retailer's net margin may be negative in some instances, meaning that this retailer is losing money on every gallon of gasoline sold.

Wholesale Gasoline Pricing

- Wholesale gasoline prices generally are tied to one of two data points:
  - A price based on a differential from the current price of a future gasoline delivery contract from a commodities exchange (New York Mercantile Exchange, a.k.a. "the Merc" or "NYMEX") or from a gasoline price tracking service, such as Platts, Oil Price Information Service, or DTN; or,
  - A price based on the "cash" or "spot" market for gasoline.
- NYMEX- or Platts-based wholesale pricing is used primarily for short- medium- and long-term contracts for gasoline supplies between refiners, blenders, importers, and traders and gasoline wholesalers and retailers. Such a contract might call for a supplier to sell a certain quantity of gasoline at "NYMEX plus 2 cents" or "local OPIS low rack minus 1 cent."
- Spot market-based wholesale pricing is used primarily by gasoline wholesalers and retailers for immediate delivery of gasoline supplies by these parties. Such pricing might call for immediate delivery of 10,000 barrels of 87 octane unleaded at New York harbor for a set price.
- NYMEX and spot market gasoline prices move independently and are influenced by many factors, including national and regional gasoline inventories, the price of crude oil, weather, and market events such as pipeline disruptions and refinery

shutdowns. When market conditions become more volatile because of weather or crude oil events, NYMEX-based prices may rise somewhat, while spot market prices may soar. A gasoline market in which spot market prices are higher than NYMEX prices for future deliveries is termed a "backwardated market" and generally indicates that the markets believe that current upward pressures on prices will ease in the future.

- Many gasoline wholesalers and retailers use the NYMEX to hedge their gasoline supply needs, thereby reducing their exposure to future gasoline price movements. However, many trades of NYMEX futures contracts are undertaken by "paper traders," brokers and speculators that never expect to take physical delivery of a gallon of gasoline from a NYMEX futures contract. These paper traders tend to lead NYMEX contract prices up or down based on market conditions and breaking news events.
- Wholesale prices for gasoline generally are reported by most sources as excluding federal, state, and local taxes, without the transportation costs from the wholesale market to the retail outlet, and do not include any retailer-related costs, including overhead, credit card fees, and any profit margin the retailer may seek. Thus, a spot market price of $2.00 per gallon for 87 octane unleaded gasoline does not include any of the below the "rack" costs and expenses that ultimately determine a retailer's "laid-in" costs of gasoline.

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